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No. 236

In The

SUPREME COURT OF THE UNITED STATES

October Term, 1924

Walter L. Marr, Appellant,

v.

The United States

Appeal From The Court of Claims.

BRIEF FOR APPELLANT.

LONG-JOHNSON, JACKSON, TENN.

SUBJECT INDEX

Authorities Cited

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WALTER L. MARR, Appellant,

vs.

THE UNITED STATES, Appellee

No. 236

Appeal from the Court of Claims.

BRIEF FOR APPELLANT.

The appellant has appealed from a decree denying him a recovery for the amount paid by him as additional income tax for 1916, together with interest.

The Facts.

Appellant and his wife made a joint return for 1916 and paid the tax shown to be due by that return. Later, the Commissioner made an additional assessment of $24,944.12, based on the theory that they had derived a profit of $324,466.57 from a single transaction in which they exchanged shares of stock in the General Motors Company, hereinafter called the New Jersey corporation, which had cost them $76,400, for $100 in cash and shares in the General Motors Corporation, herinafter called the Delaware corporation, which had a market value of $400,766.57.

This assessment was paid by appellant, under protest, January 7th, 1922, and all steps necessary were taken to entitle him to sue.

The facts are undisputed and are set out in a stipulation which was adopted as the findings of the court, (Rec. p. 4) from which it appears that the transaction was as follows:

The New Jersey company had outstanding $15,000,000 of 7% preferred stock and $15,000,000 of common stock of the par value of $100 per share, and had accumulated a large surplus so that the book value of the common stock was $842.50 per share. In order to keep this surplus in the business and, at the same time, give stockholders a greater number of shares, so that a part of their holdings could be more readily disposed of, the directors submitted to the stockholders a plan of reorganization which, they said, would "afford a more liquid and satisfactory investment and eventually will lead to economies in administration to the benefit of all shareholders." (Rec. p. 6).

Under this plan, they organized the Delaware corporation with an authorized capital of $20,000,000 of 6% preferred stock and $82,600,000 of common stock of the par value of $100 per share. The new preferred stock was to be exchanged for the old preferred at the rate of 1 1/3 shares for one so as to adjust the value of 7% stock to that of 6% stock. Thus the $20,000,000 of new preferred stock was to be exchanged for the $15,000,000 of old.

Of the $82,600,000 of new common stock, $75,000,000 was to be exchanged for the $15,000,000.00 of old common at the rate of five for one, and the remaining $7,600,000.00 was to be held to be sold as additional capital. Accordingly, each stockholder of the New Jersey corporation was offered 1 1/3 shares of the new preferred 6% stock for each share of his old 7% stock and five shares of the new common stock for each share of his old common stock. But to avoid issuing fractional shares of preferred stock, it was stipulated that any stockholder who would be entitled to a fractional share of the new preferred stock would be paid in cash for such fractional share at the rate of $100 per share. In other words the stockholders were to exchange their holdings at the rate of 1 1/3 for one and then to sell, for cash, any fractional shares that would be coming to them.

The offer was accepted by all the holders of common stock and $75,000,000 of the new common stock was exchanged for the $15,000,000 of old. The market value of each share of new common stock was $168.50—exactly one-fifth of the value of one share of the old.

All the holders of the preferred stock also accepted, except the holders of a few shares. These shares were paid off in cash and retired.

The Delaware corporation thus became the owner of all the outstanding stock of the New Jersey company and had authorized but unissued $7,600,000 of common stock and a few shares of preferred stock.

The old company was then dissolved and all its assets and liabilities transferred to the new corporation. The business was continued under the same management without interruption and with the same assets and liabilities, except that some additional capital may have been provided by the sale of some of the new stock not used in making the exchange. (Rec. p. 7).

Appellant had 15 shares of common and 11 shares of preferred stock for which he received 75 shares of common and 14 shares of preferred, and was paid $66.67 for two-thirds of a share of preferred to which he was entitled. His wife had 410 shares of common and 328 shares of preferred stock for which she received 2050 shares of common and 437 shares of preferred and was paid $33.33 for one-third of a share of preferred stock to which she was entitled. Together they had 425 shares of common and 339 shares of preferred stock for which they received 2125 shares of common and 451 shares of preferred and were paid $100 for two fractional shares to which they were entitled.

Their old stock had cost $76,400. The market value of the new was $400,766.57 and, in addition, they received $100 in cash. The difference, or $324,466.57, has been treated as taxable income under the Revenue Act of 1916. 39 Stat. ch. 643, pages 756 et seq. (Rec. p. 7).

What they did, therefore, was to dispose of two fractional shares, amounting to one whole share, for $100. This share represented three-fourths of a share of the old stock which had cost them $75.00. By disposing of it they realized a profit of $25.00. The remainder of

their interest in the enterprise they retained by exchanging their shares for shares of equal value in a corporation authorized to carry on the same business and organized for the express purpose of continuing the enterprise in which their money was invested.

Questions Involved.

The questions for decision are:

(1) Did appellant and his wife, by this transaction, dispose with profit of all, or only two fractional shares, of their stock in the New Jersey company within the meaning of the Revenue Act of 1916?

(2) If so, are those provisions constitutional?

Assignment of Errors.

The court below was in error in denying appellant relief because:

1st. No income was derived through the transaction in question within the meaning of the Revenue Act of 1916 when properly construed, except as to the one share disposed of for cash.

2nd. Since no income was, in fact, realized, if the Revenue Act of 1916 authorizes the assessment in question, it is unconstitutional.

Gains resulting from an investment in property do not become income so long as they remain in the investment.

That large gains have accrued to appellant's investment in the stock of the New Jersey company is, of course, true. But the question is whether when, in 1916, he exchanged for certificates of the Delaware corporation, he received these gains in the form of income.

What is necessary to convert such gains into income was determined in Eisner v. Macomber, 252 U. S. 189, in this language:

> The Government, although basing its argument on the definition as quoted, places chief emphasis

upon the word "gain" which was extended to include a variety of meanings; while the significance of the next three words was either overlooked or misconceived—*"Derived from capital"*; *the gain derived from capital," etc.* Here we have the essential matter: *not* a gain *accruing* to capital, not a *growth* or *increment* of value in the investment; but a gain, a profit, something of exchangeable value proceeding from the property, *severed from the capital* however invested or employed, and *coming in*, being "derived," that is *received* or *drawn* by the recipient (the tax payer) for his separate use, benefit and disposal; *that is* income derived from property. Nothing else answers the description.

— II —

An exchange of stock certificates for others evidencing substantially the same property interest withdraws nothing from the enterprise and gives the stockholder nothing for his separate use.

Eisner v. Macomber dealt with stock dividends and the precise point determined was that a stock certificate issued as a dividend only gave the stock holder two certificates to evidence his ownership of what he had previously held under one certificate. But the principle is the same, of course, when he surrenders one certificate and receives others in exchange evidencing the same proportionate [illegible] property interest. His capital with its accrued but unsevered gains [illegible].

In Weiss v. Stearns (decided May 26, 1924), speaking of Eisner v. Macomber, Mr. Justice McReynolds said:

> It pointed out that, within the meaning of the Sixteenth Amendment, income from capital is gain severed therefrom and received by the tax payer for his separate use; that the interest of the stockholder is a capital one and stock certificates but evidence of it; that for the purposes of taxation where a stock dividend is declared, the essential and controlling fact is that the recipient receives nothing out of the company's assets for his separate use and benefit.

The conclusion was that "having regard to the very truth of the matter, to substance and not to form, he has received nothing that answers the definition of income within the meaning of the Sixteenth Amendment."

— III —

This case is ruled by Weiss vs. Stearns, supra.

The opinion in Weiss v. Stearns, decided since this case was determined in the court below, makes it plain that no income results to the stockholder when the ownership of the corporate assets passes to a new corporation organized for the same general purpose and the stock holder receives, in exchange for his old certificates, certificates of the new company evidencing substantially the same interest in the same corporate assets, because, in such a case, it can not be said that the stockholder has disposed of his investment.

In the Weiss case, the owners of the entire capital stock ($5,000,000) of the National Acme Manufacturing Company, an Ohio corporation, sold to Eastman, Dillon & Company one-half of their holdings for [illegible] The National Acme Company, another Ohio corporation with similar powers, was organized with [illegible] [illegible] man, Dillon & Company received the other [illegible] in exchange for the shares of the old company which they had bought.

It was not disputed that the half of the stockholder's holdings which had been sold to Eastman, Dillon & Company had been disposed of at a profit which constituted taxable income. And the question was whether the shares exchanged had likewise been disposed of at a profit.

In the present case, the stockholders surrendered all their certificates and, in exchange, received the certificates of a new company organized to take over and continue the business, their several interests in the enter-

prise remaining the same. Those of them who became entitled to fractional shares disposed of these shares for cash. It is not disputed that, so far as the cash received included a profit on the shares disposed of, there was income.

The case differs from the Weiss case only in these unimportant details.

(1) All the authorized capital of the new company was not needed to effect the change. After $75,000,000 of its common stock had been exchanged for the $15,000,000 common stock of the old company, it still had authority to issue $7,600,000 of common stock which it was at liberty to sell as additional capital should be needed.

(2) The holders of a few shares of preferred stock did not exchange and their shares were paid off and retired. Thus a few shares of the authorized preferred stock remained unissued.

(3) While the new corporation was organized with authority to carry on the same general business as the old, it was chartered by a different state.

In the Weiss case, it was said:

> The practical result of the things done was a transfer of the old assets and business, without increase or diminution or material change of general purpose, to the new corporation; a disposal for cash by each [illegible] an exchange of the remainder for new shares representing the same proportionate interest in the enterprise. Without doubt, every stockholder became liable for the tax on any profits which he actually realized by receiving the cash payment. If by selling the remainder he hereafter receives a segregated profit, that also will be subject to taxation.

In denying appellant relief, the court below was of opinion that the case was ruled by United States v. Phellis, 257 U. S. 156, Rockefeller v. United States, 257 U. S. 176, and Cullinan v. Walker, 262 U. S. 134. These same cases were relied on in the Weiss case. But the court, holding them inapplicable to a case like this, said:

As the result of transactions disclosed in the Phellis and Rockefeller cases, certain corporate assets not exceeding accumulated surplus were segregated and passed to individual stockholders. The value of the segregated thing so received was held to constitute taxable income.

Cullinan's gain resulted from a dividend in liquidation actually distributed in the stock of a holding company incorporated under the laws of a foreign state, not organized for the purpose of carrying on the old business, and which held no title to the original assets.

The Weiss case, looking to substance and not to form, applies the principle of Eisner v. Macomber to results which do not, in fact, segregate income from the stockholder's investment, whether these results be accomplished through changes in the organization of the original company or through the passing of the same corporate assets to a new company organized for that purpose. Thus it was said:

> Applying the general principles of Eisner v. Macomber, it seems clear that if the National Acme Manufacturing Company had increased its capital stock to $25,000,000 and then declared a stock dividend of four hundred per cent., the stockholders would have received no gain—their proportionate interest would have remained the same as before. If, upon the transfer of its entire property and business for the purpose of reorganization and future conduct, the old corporation had actually received the entire issue of new stock, and had then distributed this pro rata among its stockholders, their ultimate rights would have continued substantially as before—the capital assets would have remained unimpaired and nothing would have gone therefrom to any stockholder for his separate benefit. The value of his holdings would not have changed, and he would have retained the same essential rights in respect of the assets.

> We can not conclude that mere change for purposes of reorganization in the technical ownership of an enterprise, under circumstances like those here disclosed, followed by issuance of new certificates constitutes gain separated from the original capital interest. Something more is necessary—something which gives the stockholder a thing really different from what he theretofore had.
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> * * * * *
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> The sale of part of the new stock and distribution of the proceeds did not affect the nature of the unsold portion; when distributed this did not in truth represent any gain.

It only remains to inquire whether there is anything in the minor differences noted above to take this case out of the rule of the Weiss case.

We have seen that, if the New Jersey company had increased its capital stock to $75,000,000 common and $20,000,000 6% preferred stock and had used the preferred stock to retire its $15,000,000 of 7% preferred stock (the two blocks of stock being equal in value) and had then declared on common stock a stock dividend of 400%, there would be no income to stockholders. And the Weiss case expressly holds that this is no less true when the business is taken over by a new corporation which issues the new stock.

If, in order to declare a stock dividend, the New Jersey corporation had required an amendment to its charter increasing its authorized capital, and, to provide for future contingencies or even to immediately sell more stock, it had increased its authorized capital to $82,600,000 and had even made an immediate sale of the $7,600,000 not needed for the stock dividend, there would have been no income to stockholders. The fact that a corporation increases its capital and sells additional stock does not convert a stockholder's holding into something that it was not before and does not represent any part of his gain from his capital.

And so, according to the Weiss case, if the New Jersey company for the purpose of reorganizing, had transferred its entire business and property to the Delaware

corporation and had received and distributed pro rata among its stockholders the entire issue of the latter company's stock, the ultimate rights of each stockholder in the enterprise would have continued substantially as before—the capital assets would have remained unimpaired and nothing would have gone therefrom to any stockholder for his separate benefit, and there would have been no income. What was done was that, upon the transfer of the business to the Delaware corporation, the stock holders of the New Jersey company received pro rata the entire amount of stock issued to pay for the business. The fact that the company still had other stock which it had sold to get additional capital, or could sell whenever deemed necessary, did not give appellant his gains separated from the original capital any more than this would have resulted if the New Jersey company had increased its capital. His capital and accumulated gains were still invested in the same enterprise. And he had received nothing for his separate use. The same enterprise was merely being conducted for him and other stockholders by a different corporate agency. The same property interest which had previously been certified to him by one corporation was now certified to by another. The fact that either corporation may have put some new capital into the business by selling additional stock can not make him liable for an income tax.

It will scarcely be claimed that the retirement of a few shares or all the preferred stock could, by any possibility, serve to separate the gains of the remaining stockholders from their original capital, any more than that this result would have followed had the old company retired some, or all, of its preferred stock.

The remaining inquiry is whether the fact that the two corporations were chartered by different states has any significance unfavorable to appellant. They were organized for the same general purpose and were empowered to carry on and did carry on the same business. Their powers must, therefore, have been, at least, similar. But if we assume that there were some differences between these powers, does this alter the case? It is not uncommon for the powers of a corporation to be materially altered by charter amendments or subsequent leg-

islation. But when this occurs, can it be said that the stockholders have something substantially different from what they had before, or that their gains have been separated from their capital?

If the laws of New Jersey permitted, the old corporation could have amended its charter so as to acquire precisely the same powers that are conferred by a Delaware charter. Those in charge of the reorganization accomplished the same thing by organizing the new corporation under the laws of Delaware. Every corporation is a distinct entity. It is no more the same entity as another corporation chartered by the same state than as one chartered by another state. Certainly a business can be passed from one corporate entity to another without separating the stockholder's gain from his capital. How then can the fact that the two corporations are chartered by different states alter the case? The enterprise in which appellant's money was invested remained the same enterprise whether those in charge went to New Jersey or Delaware for a corporate agency to conduct it. He could receive nothing out of the gains which accrued to his investment so long as those gains remained in the same assets whether owned by one corporation or the other.

It happened that in the Cullinan case the new corporation was chartered by a different state. And Mr. Justice McReynolds, in the Weiss case, referred to it as "incorporated under the laws of a foreign state, not organized for the purpose of carrying on the old business, and which held no title to the original assets." But there is nothing in his reasoning which would attach any significance to the State which chartered it if that fact stood alone. The essential fact was that *it was not carrying on the business in which the old company had been engaged and owned none of the property of that company.*

If the stock of a corporation engaged in a manufacturing business is exchanged for stock in a bank or a railroad or a holding company, the stockholder, of course, acquires something substantially different from what he had before. And, assuming that, by the exchange of one piece of property for another of equal value, but of a different species, the original investment is liquidated

and he realizes his profit, there would be income. But where he merely exchanges a certificate of one corporation for that of another evidencing his ownership of an interest in the same business, he has substantially the same property interest that he had before. The reorganization may result in making his interest more valuable just as the substitution of an efficient for an inefficient general manager might produce that result. But his capital, with its accumulated gains, is still embarked in the same enterprise and he has derived from his investment nothing for his separate use and benefit.

Considering the entire arrangement it amounted to a financial reorganization under which appellant disposed of two fractional shares and retained the remainder of his interest. In such a transaction it can not be said that, except as to the two fractional shares disposed of, any part of his gains have been separated from his capital. Clearly the Weiss case rules this case.

— IV—

Subsequent Revenue Acts make it plain that, by the Act of 1916, Congress did not mean to treat a transaction like this as resulting in income.

The conclusion stated above is in accord with the interpretation which Congress itself has placed upon its legislation.

Since Congress could not make this tax apply to anything which is not, in fact, income, we can not assume that it intended to treat as income unsegregated gains merely because the form of property or the evidence of its ownership has been changed. And a review of the statutes shows that its intention was quite the contrary.

The earlier income tax acts were more or less meagre. As the system was developed, experience indicated, from time to time, the necessity of defining things which had been left undefined in earlier acts. It resulted that the later acts usually contained a long list of definitions of terms and expressions which, as used in previous acts, had given rise to confusion in the administration of the law. Hence just what was meant by certain provisions

of the earlier acts is best seen in the light of what Congress, in later acts, said when it came to cover, by express provisions, matters which had previously been left to the construction of general language.

The language of the Act of 1916, under which this assessment was made was very general. 39 Stat. ch. 643, pp. 756 et seq. Section one imposes a tax on *net income received* from all sources. And section 2 (a) defines net income as "gains, profits, and income derived from," among other things. "sales or dealings in property, whether real or personal."

It may be assumed that Congress intended to tax such income as should, in fact, be realized through the *exchange* of property, for in Section 2 (c) it lays down a rule for determining "the gain *derived from the sale or other disposition* of property" acquired before March 1st, 1913. It did not, then, however, see the necessity of specifically defining the *exchange* that would result in income.

In the administration of the law, the Treasury Department construed it as applying to gains realized by the exchange of property but in the regulations promulgated did not define the kinds of exchanges which would realize gains.

Congress supplied the definition in the Act of 1918 as follows:

> When property is exchanged for other property, the property received in exchange shall for the purpose of determining gain or loss, be treated as the equivalent of cash to the amount of its fair market value, if any. 40 Stat. ch. 18, Sec. 202 (b).

The Treasury Department properly interpreted both the Act of 1916 and that of 1918, in Regulations 45, Article 1563, as follows:

> Gain or loss arising from the acquisition and subsequent disposition of property is realized when, as the result of the transaction between the owner and another person, the property is converted into property (a) that is essentially different from the prop-

erty disposed of and (b) that has a market value. In other words, both (a) a change in substance and not merely in form, and (b) a change into the equivalent of cash, are required to complete or close a transaction from which income may be realized.

But there was still uncertainty as to when property exchanged and that received in exchange could be said to be essentially different and not substantially the same property in a new form, because Congress had not laid down any rule as a guide. It furnished this rule in the Act of 1921, as follows:

> For the purpose of this title, on an exchange of property, real, personal or mixed, for any other such property, no gain or loss shall be recognized unless the property received in exchange has a readily realizable market value; but even if the property received in exchange has a readily realizable market value, no gain or loss shall be recognized—
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> (1) When, &c.
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> * * * * *
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> (2) When in the reorganization of one or more corporations a person receives in place of any stock or securities owned by him, stock or securities in a corporation a party to or resulting from such reorganization. The word "reorganization" as used in this paragraph, includes a merger or consolidation (including the acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation, or of substantially all the properties of another corporation), recapitalization, or mere change in identity, form, or place of organization of a corporation however effected). 42 Stat., ch. 136, Sec. 202 (c) (1) and (2), p. 230.

Beginning with the Act of 1916 and running through all subsequent Acts is the expressed purpose to tax *income from all sources.* Under the language of the Act of 1921 transactions like the one in question are ex-

pressly excluded from the definition of those transactions which produce income. Since both Acts express the purpose to tax everything that is, in fact, taxable income, what Congress said in the latter Act in defining income-producing exchanges of property may properly be taken to define what it intended to tax by the general language of the former.

As we have seen, it first, by the Act of 1918, made it plain that by an income producing exchange of property, it meant the exchange of property for essentially different property with a market value. And finally, by the Act of 1921, evidently to remove uncertainties which had arisen as to when two properties were essentially different, it enacted, in effect, that stock in one corporation is not essentially different property from stock of another corporation received in exchange as the result of a reorganization or the purchase by the latter of substantially all the properties of the former, regardless of the *place of organization* of the new corporation.

There is no reason to believe that, by this, Congress intended to withdraw from taxation anything which it had intended to tax by previous acts. On the contrary, in Section 213, it repeated the purpose, which had been expressed in all previous acts to tax all gains that were, in fact, income, by concluding its definition with the words "or gains or profits and income derived from any source whatever." There can scarcely be a doubt that Congress excluded such exchanges from income-producing transactions because it recognized that they did not, in fact, produce income but merely changed the form of the investment. Nothing was taken from what had, in the contemplation of Congress, previously been income under the Act of 1916. It had, from the beginning, authorized the taxing of all income derived from the exchange of property. It now did what it had not previously done, defined the circumstances under which it understood that income is derived from such exchanges.

— V —

The tax in question was not one apportioned among the states. It is invalid, therefore, if what has been

taxed is not, in fact, income. We have endeavored to show that there was nothing that could properly be called income and have construed the Act of Congress as not intended to tax anything but income. If we are right in the contention that there was no income but the Act of Congress be construed to authorize the tax assessed in this case, it is, of course, unconstitutional.

Respectfully submitted,

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October, 1924.